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**SENATE COMMERCE, SCIENCE, AND TRANSPORTATION COMMITTEE**

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I am here today to relate to this Committee my experiences in class action litigation where the main issue was bankruptcy versus settlement. I am an economist. My remarks here today are based upon that perspective. I am not an attorney and I am not qualified to speak to distinctly legal issues.

I have had a great deal of experience with the question of bankruptcy and reorganization verses settlements and limited funds. It has been my privilege over the past 30 years to work very closely with the court system in this country. I have been appointed by four State and three federal courts to assist them in assessment of damages and the equitable distribution of funds that have been set aside for plaintiffs/victims in class action litigation, and I have recently been appointed a Special Master in similar litigation.

Is the threat of bankruptcy real if a settlement falls through; or, what is the effect if Congress imposes a settlement with conditions that are so financially or otherwise restrictive that one or more of the participants is forced into bankruptcy anyway?

We are all familiar with companies like AH Robbins in the Dalkon Shield litigation (1985), Dow Corning in the breast implant litigation (1995), and Johns Manville in the asbestos litigation (1982). These companies all chose or were forced into bankruptcy because they were unable to negotiate an equitable settlement as a means of dealing with the overwhelming litigation they faced. These bankruptcies were unique because none of these companies were insolvent at the time they filed for relief. They simply made a business decision to deal with huge contingent liabilities that "potentially" could lead to bankruptcy. The objective, of course, was to mitigate potential liabilities and delay the need to pay on a large number of claims.

There are a number of different techniques available for the prediction

of bankruptcy. Professor Altman, at New York University, developed a statistical technique more than 25 years ago. This technique combines accounting and financial market data, and provides a more objective ability to forecast the probability of bankruptcy up to three years prior to the event. The model has endured over the years and has been continuously refined. It's durability stems from the fact that the technique is easy to apply and understand, and more importantly, has been quite accurate in forecasting bankruptcy.

The second technique is financial ratio analysis, a more traditional bankruptcy analysis. This approach is more qualitative than Altman's, and uses information and data from credit reporting agencies such as Dun and Bradstreet. The analyst compares certain financial ratios from an industry to the same ratios of the company in question, and then infers from the comparison the financial health of that company.

The final technique is a more traditional cash flow analysis that would generally be used in cases in which the company has limited funds. The

firm's estimated value is compared to an estimate of the present value of future claims that are likely to be filed against the company. This method, sometimes called "Closed Claims" analysis, was widely used in the asbestos litigation.

While these techniques do exist, it is important to stress that predicting bankruptcy is not an exact science. We cannot be certain how far a company can be pushed, or at what point the terms of a settlement are made so restrictive that a company makes a business decision to seek the protection of the bankruptcy laws. We do know, however, that the threat of bankruptcy is real and its consequences are unsatisfactory and serious.

Bankruptcy is expensive. Recent research by economists and financial analysts have found that bankruptcy costs can be as much as ten to sixteen percent of the company's value when all of the direct and indirect costs are taken into account. Even when the company is not in bankruptcy the costs of dealing with settlements and especially trials, can overwhelm a company and ultimately force them into bankruptcy. In a recent fairness hearing involving

a company in the pedicle screw litigation, testimony showed just how expensive litigation could be. Even if the company successfully won every trial and even if the company paid minimal settlements, the company was incapable of funding the legal expenses associated with the high cost of processing each case from discovery through trial. It is pretty clear that the recent litigation tactics of the state attorneys general and the Castano group raised this very problem for Tobacco, and caused Tobacco to come to the table and negotiate a settlement.

The bankruptcy costs mentioned above, of course, don't take into account the costs incurred by others when a company declares bankruptcy. Creditors, equity holders, debt holders, and plaintiffs must all seek legal representation. Another group that sometimes needs representation is future plaintiffs who are unknown at the time of the bankruptcy filing because they may not develop an illness until some time in the future. Usually a Special Master is appointed by the court to represent this group. In addition to legal representation, each group requires its own accountants, financial analysts, or other specialized experts to help protect their interests as each group

competes for the assets of the firm. It is a virtual bonanza for lawyers and experts.

I want to tell you about the experiences of two lesser know companies. Their experience offers an interesting contrast and insight into the questions facing this Committee. Eagle Picher, an Ohio corporation, had negotiated a settlement of all its asbestos claims in December, 1990. There was a fairness hearing held in Brooklyn, New York. Eagle Picher had warned that in the absence of settlement approval the company would be force into bankruptcy. Much of the fairness hearing held in New York dealt with whether or not this was a real threat or was made to help force acceptance of the settlement. My partner, John Burke, and I applied the Altman analysis to Eagle Picher's financial data and concluded that the threat of bankruptcy was real.

Unfortunately, we were right. The settlement disintegrated and within 48 hours after the hearing was concluded, Eagle Picher filed for Chapter 11 bankruptcy protection. It wasn't until 1997, six years later, that the plaintiff/victims could be compensated again.

This experience contrasts dramatically with the litigation involving a California corporation called the Mentor Corporation, a producer of silicone breast implants. Like Eagle Picher, Mentor threatened that if a settlement was not reached and approved, they too would be forced into bankruptcy. A settlement was reached and with in several months the court approved the settlement. Unlike Eagle Picher plaintiffs – who had to wait six years – funds were available for distribution in less than a year. To this day, the Mentor class is the only group of breast implant plaintiffs who are almost completely compensated for the injuries related to Mentor's product.

The lesson is very clear. Bankruptcy means chaos and uncertainty. Bankruptcy is good for experts and lawyers. Bankruptcy is bad plaintiffs. During bankruptcy the attorneys get paid, the experts get paid, and the officers of the Corporation get paid. But, the plaintiff/victims wait and wait. In the case of Eagle Picher they waited for over six years. Even those who had judgements against the company prior to the bankruptcy had to wait.

Settlements are orderly. Procedures and protocols can be put into place so that plaintiff/victims can begin to receive fair compensation as soon as possible. Not only is it quicker, but the compensation is generally more equitable in that all of the claims are treated uniformly and consistently. It is not a race to the courthouse to see who can get there first; or who is lucky to get the large verdict and the most compensation. It is not a matter of whether one of the States cases or someone in the Castano litigation wins big, as all the victims receive equal treatment under the settlement.

Finally, another issue facing the Committee is the prospect that in the future one of the tobacco companies could declare bankruptcy due to penalties included in the settlement. The "look-back" provision of this settlement agreement provides for certain penalties that can be imposed if the rate of smoking by youth or under-age tobacco users is not met. Some fear that if these penalties were too severe, it could weaken some of the companies to the point that they would seek bankruptcy protection. Normally, without a settlement those plaintiffs that already had judgements or those that were still negotiating or trying their claims would be out of luck. They would

have to stand in line with all other creditors. Those not lucky enough to have a judgement would have even lesser a claim against the company assets.

An important feature of this settlement is that it does provide some protection to claimants against the future bankruptcy by one of those companies. The remaining solvent tobacco companies are still obligated to pay their proportionate market share into the settlement fund. Even though the claimant may not get 100 cents on the dollar, they will receive something without delay, while they are waiting for some residual compensation from the bankruptcy proceedings.

In conclusion, a significant settlement in which the companies avoid the protection of bankruptcy is almost always better than the prospect of relief through those statutes. The Congress has the difficult burden of weighing the best way to achieve the most for the nation's public health. In the name of getting tough on Tobacco, there is a real threat that we could end up with an unsatisfactory result.